Nos. 03-892 and 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

SUPPLEMENTAL BRIEF FOR THE PETITIONER

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This supplemental brief is filed pursuant to Rule 25.5 of the Rules of this Court to bring to the attention of the Court legislation that was enacted after the briefs of the United States were filed in this case. Oral argument in these cases is scheduled for November 1, 2004.

After the government filed its reply brief, Congress enacted legislation relevant to these cases. That legislation neither moots this litigation nor eliminates the ongoing significance of the question presented. The legislation does, however, confirm the correctness of the Commissioner's treatment of the litigation awards at issue.

1. The government's reply brief (at 18) indicated that Congress was considering a bill that would provide an above-the-line deduction under 26 U.S.C. 62 (2000 & Supp. I 2001)—i.e., a deduction that would be allowed in computing the alternative minimum tax (AMT)—for attorney's fees and costs paid in connection with any action involving a claim of unlawful discrimination. That proposed legislation has now been enacted into law. On October 11, 2004, Congress passed the American Jobs Creation Act of 2004 (the Act), and the President signed the Act into law on October 22, 2004.

Section 703 of the Act (App., *infra*, 1a-3a) is entitled "Civil Rights Tax Relief." Section 703(a) amends Section 62(a) of the Internal Revenue Code to provide a deduction from gross income for, *inter alia*, "[a]ny deduction allowable under [chapter 1 of subtitle A of the Code] for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination." *Id.* at 1a.

Section 703(b) of the Act defines "unlawful discrimination," as that phrase is used in Section 703(a), to mean "an act that is unlawful" under any of a number of specifically identified federal civil rights and anti-discrimination laws, as well as any conduct that falls within either of two catch-all clauses. App., *infra*, 1a-2a. The first of those more general provisions (adding Section 62(e)(17)) includes within the definition of "unlawful discrimination" any conduct that violates any

federal "whistleblower protection" law, and the second (adding Section 62(e)(18)) encompasses "[a]ny provision of Federal, State, or local law, or common law claims * * * regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law." *Id.* at 3a.

Congress expressly provided that the Act would have purely prospective application. Section 703(c) specifies that the Act's amendments to Section 62(a) "shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date." App., *infra*, 3a.

2. The newly enacted legislation, although relevant to the question presented in these cases, does not render these cases moot or eliminate the continuing importance of the question presented.

First, the legislation does not apply retroactively to respondents' claims. As explained above, Section 703 applies only to "fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date." App., *infra*, 3a. Thus, although Section 703 would permit a deduction for individuals who bring employment-related claims and pay fees and costs with respect to judgments or settlements occurring after October 22, 2004, the Act does not retroactively authorize any deduction for respondents.

Second, the question presented in these cases remains of continuing importance. The deduction allowed by Section 703 is limited to attorney's fees and costs in cases involving claims of "unlawful discrimination," as

defined in the Act. In contrast, the question presented —"[w]hether * * * a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement" (Banks Pet. I)— potentially arises in any case in which the plaintiff retains a lawyer pursuant to a contingent-fee agreement. Contingent-fee arrangements are a routine feature of many types of litigation other than employment discrimination and civil rights cases. Section 703 thus does not affect the tax treatment of the contingent-fee portion of litigation proceeds in a wide array of cases, such as state tort law claims for defamation, intentional infliction of emotional distress, breach of contract, or unfair competition,[1] or federal claims for violation of the securities, antitrust, patent, trademark, or copyright statutes. The issue also arises in personal injury cases to the extent punitive damages or other damages not "on account of personal physical injuries or physical sickness" are awarded. 26 U.S.C. 104(a)(2) (2000 & Supp. I 2001); see Pet. Br. 15 n.3.

Moreover, nothing in the courts of appeals' decisions in these cases turned on the fact that the claims arose in the employment context. Accordingly, whether the contingent-fee portion of litigation proceeds are includable in the plaintiff's gross income under Section 61(a) of the Code is an issue that will continue to arise, and to do so frequently, notwithstanding Congress's enactment of Section 703. Many of the cases cited in

[1] Indeed, respondent Banks originally sued not only for alleged violations of federal anti-discrimination statutes, but also for defamation, intentional infliction of emotional distress, and tortious interference with business relations in violation of state law. See Pet. App. 2a-3a.

the petitions for certiorari in these cases, for example, involved claims that would not be covered by Section 703. See, *e.g.*, *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001) (property dispute between former spouses); *Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001) (fraud claim); *Srivastava* v. *Commissioner*, 220 F.3d 353 (5th Cir. 2000) (defamation claim); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000) (personal injury claim); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995) (condemnation action); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959) (will contestation action). The question presented in these cases therefore remains an issue of continuing importance for this Court to resolve.

3. Although Section 703 is not directly applicable here, its enactment provides additional support for the Commissioner's position in these cases. First, Section 703 confirms the Commissioner's position that gross income, as defined in Section 61(a) of the Code, includes the entire amount of a litigation recovery, including any part that is paid to an attorney under a contingent fee agreement. In enacting Section 703, Congress did not exclude any portion of litigation proceeds from gross income, as, for example, it did in Section 104(a) and (2) with respect to physical injury damages. See 26 U.S.C. 104(a) and (2) ("gross income does not include * * * the amount of any damages (other than punitive damages) received * * * on account of personal physical injuries or physical sickness"). Rather, Congress recognized that the entire amount of litigation proceeds constitutes gross income and provided an above-the-line *deduction* from gross income *for* certain litigation *expenses*, in-

cluding attorney's fees.[2] If respondents and the courts of appeals below were correct that the contingent fee portion of litigation proceeds is excluded from gross income altogether under Section 61(a), it would have made no sense for Congress to create a new above-the-line deduction under Section 62(a) for attorney's fees and costs associated with certain civil rights suits.[3]

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[2] The Conference Committee's Joint Explanatory Statement accompanying the Act, although acknowledging the current circuit conflict over the treatment of contingent fees, confirms that "present law" generally takes this approach. It explains that with the exception of personal injury damages which are expressly excluded from a taxpayer's gross income:

> [o]ther damages are generally included in gross income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as expenses for the production of income, subject to the two-percent floor on itemized deductions. Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount. For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 471 (2004).

[3] Any attempt by respondents to rely on a floor statement by Senator Grassley, 150 Cong. Rec. S11,036 (daily ed. Oct. 10, 2004), to the effect that Section 703 was intended to "clarify" rather than change existing law would be misplaced. In that statement, Senator Grassley stated his opinion that Congress never intended to include "attorneys' fees and other costs" in a taxpayer's taxable income, and that Section 703 clarifies that fact. *Ibid.* As an initial matter, it is clear that Senator Grassley was referring to a prior version of the bill that would have given Section 703 at least partial retroactive application. The bill Congress *actually* passed, however, expressly provided for prospective application only. In any event, such individual statements are generally an inadequate indicator of congressional intent. See, *e.g.*, *Fidelity Financial Servs., Inc.* v. *Fink*, 522 U.S. 211, 220 (1998). That is particularly true here, where the relevant statutory language, Section 61(a)'s definition of "income," has been unchanged since the enactment of the 1954 Internal Revenue Code. See *South Dakota* v. *Yankton Sioux Tribe*, 522 U.S. 329, 355 (1998) (characterizing subsequent legislative history as "a hazardous basis" on which to infer congressional intent). Moreover, Section 703 obviously works a change in existing law, as reflected by Congress's decision to make the application of the Section prospective only. Like the new legislation itself, Senator Grassley's statement speaks generally to "attorneys' fees," and is not limited to contingent fees. Yet it is undisputed that prior to the enactment of Section 703, such fees paid on an hourly basis were included in a taxpayer's gross income without deduction under the AMT. It is therefore beyond dispute that Section 703 changed existing tax law, notwithstanding Senator Grassley's statement to the contrary.

Second, Section 703 illustrates Congress's ability to rectify any perceived unfairness arising from the application of the AMT to certain types of litigation proceeds. This narrowly tailored congressional resolution fully addresses the policy concerns raised by respondents and their amici about the tax effect on civil rights cases, and it does so without working any revolution in the definition of gross income or in the application of longstanding principles of federal tax law. Respondents and the courts of appeals below, by contrast, would distort federal tax law principles in order to alter the tax treatment of *all* contingent fee awards, without any basis in the statutory text.

Third, the new deduction created by Section 703 is not limited to contingent-fee payments, but instead encompasses all payments of attorney's fees without regard to the nature of the fee arrangement. Section 703 thus accomplishes its goals without creating any

disparity in the Code between the treatment of attorney's fees paid on an hourly basis and those paid on a contingent basis, thereby maintaining the Code's neutral treatment of contingent and hourly fees. The judicial exception advocated by respondents and adopted below, on the other hand, would make potentially dramatic tax consequences turn on the fortuity of whether the plaintiff's lawyer was retained on an hourly-rate, rather than a contingent-fee, basis. Nothing in the Code justifies such an anomalous preference for contingent-fee arrangements, as Section 703 again confirms. See Pet. Br. 24-25; *Kenseth* v. *Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001) (Posner, J.) (explaining that, with respect to tax liability, it makes no difference "that the expense happened to be contingent rather than fixed").

* * * * *

For the foregoing reasons, and for the reasons stated in our opening and reply briefs, the judgments of the courts of appeals should be reversed with respect to the issue of the tax treatment of contingent attorney's fees.

Respectfully submitted.

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OCTOBER 2004

APPENDIX

SEC. 703. CIVIL RIGHTS TAX RELIEF.

(a) **Deduction Allowed Whether or Not Taxpayer Itemizes Other Deductions.**—Subsection (a) of section 62 (defining adjusted gross income) is amended by inserting after paragraph (18) the following new item:

> "(19) Costs involving discrimination suits, etc.-Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.".

(b) **Unlawful Discrimination Defined.**—Section 62 is amended by adding at the end the following new subsection:

> "(e) **Unlawful Discrimination Defined.**—For purposes of subsection (a)(19), the term 'unlawful discrimination' means an act that is unlawful under any of the following:

"(1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).

"(2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).

"(3) The National Labor Relations Act (29 U.S.C. 151 et seq.).

"(4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).

"(5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).

"(6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).

"(7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).

"(8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).

"(9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).

"(10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).

"(11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).

"(12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).

"(13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).

"(14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).

"(15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).

"(16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).

"(17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.

"(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law-

"(i) providing for the enforcement of civil rights, or

"(ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law."

(c) **Effective Date**.—The amendments made by this section shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date.